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SUBJECT: A Primer for Hong Kong Power Reforms

Ref: Hong Kong 1976

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11. (SBU) Summary: In late December 2005, the Hong Kong Government (HKG) proposed to reform the Scheme of Control Agreements (SCAs) governing Hong Kong's electricity market to lower the rates of return to both of Hong Kong's power companies, Hong Kong Electric (HKE) and China Light and Power (CLP). (CLP is a joint venture with ExxonMobil and represents the largest U.S. investment in Hong Kong.) The reforms also aim to open the door to new investors, strengthen compliance with Hong Kong's environmental regulations, and minimize the development of excess generation capacity. This cable follows up on reftel with an analysis of the potential benefits and risks of the key new proposals. Given public perceptions that the power companies are responsible for much of Hong Kong's air pollution and that electricity prices in Hong Kong are excessively high, we assess that the HKG is in a strong negotiating position to achieve its goals. However, we caution that the HKG's proposals, if fully adopted, have the potential to lower the reliability of Hong Kong's electricity service and may not achieve the lower tariffs and environmental benefits the HKG is seeking. There are four clear benefit/risk scenarios that can be drawn from the HKG proposals: (a) reduced rates of return after 2008 and more frequent tariff reviews could lead to lower electricity rates but also to a commensurate (and offsetting) increase in the financial risks faced by the power companies; (b) linking the power companies' rates of return to their achievement of emission reduction targets could strengthen compliance with environmental controls but could skew investment decisions; (c) tightly controlling "excessive investment" on generation facilities could prevent the power companies from unnecessary spending for the sake of greater returns but could also deter necessary new investments; (d) opening Hong Kong's electricity sector to new investors and power supply from Mainland China over the long term could introduce competition and flexibility into the power generation market but risk damaging the reliability of Hong Kong's power supply. End Summary.

Overview

12. (SBU) On December 30, 2005, the Hong Kong Economic Development and Labour Bureau (EDLB) issued a Stage II

Consultation Paper that laid out the HKG's proposed reforms to the electricity sector (see reftel). Those proposals come in advance of the expiration in 2008 of the 15-year bilateral Scheme of Control Agreements (SCAs) between the HKG and the two power companies, HKE and CLP. ExxonMobil is a joint-venture partner with CLP through the Castle Peak Power Company. The HKG expects to issue its final proposal for electricity reforms by the end of 2006, which will become the basis for its negotiations with HKE and CLP. If negotiations do not lead to a mutually agreeable solution by the end of 2008, the HKG is likely to extend the existing SCAs in the interim. Overall, the HKG proposes to continue the current regulatory system of bilateral contracts, which has historically allowed Hong Kong to enjoy a 99.99% reliable supply of electricity - meaning that Hong Kong enjoys one of the most reliable supplies of electricity in the world. However, the HKG has also responded to criticisms that the SCAs' inflexible terms have led to excess returns over-investment by proposing lower permitted rates of returns, tighter regulatory controls and the possibility of increased competition.

Lower Proposed Returns to the Power Companies

13. (SBU) The HKG has proposed lowering the permitted rate of return on fixed assets to 7-11% from 13.5% (15% for assets financed by shareholder funds). Instead of a flat rate return on all assets, as is currently the case, the HKG proposes an integrated approach that sets the rate of return based on the risk-adjusted costs of raising capital, to be re-evaluated every 5 years to reflect prevailing economic conditions. Furthermore, the HKG has proposed varying the rate of return for different types of assets (generation, transmission, distribution, renewable energy, etc). Miranda Chiu, advisor to the EDLB on energy policy and the HKG on the proposed electricity reforms, said: "In Hong Kong,

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people strongly believe that returns [to the power companies] are exorbitantly high. Interest rates have fallen since the agreements were signed 15 years ago." According to Chiu, the companies are able to finance their investments for significantly less than they receive from the fixed rate of return, allowing them to earn excess returns. (When the last SCAs were signed in 1993, the prevailing interest rate was 6.5%; since then, it has fallen as low as 5.0% and has moved as high as 10.0%. As of January 2006, it was 7.75% and rates were trending upwards.)

14. (SBU) EDLB Secretary Stephen Ip commented after the proposals were released that the actual level of permitted rate of return would likely be about 9-10%, leading to a 10-20% reduction in power tariffs. The Hong Kong Legislative Council added its voice to the debate on February 15, 2006, by voting 44-3 to cap HKE and CLP's rate of return on fixed assets at 7%. Since the SCAs are bilateral contracts not governed by legislation, the vote was non-binding on the HKG but indicated the public's disapproval of high electricity rates.

15. (SBU) The HKG's proposed rate reduction took the power companies and securities analysts by surprise. CLP expressed "grave concerns" that the HKG's proposed return levels were too low to support reliable and safe power and environmental responsibility, while HKE called the proposed reductions "drastic." According to Betty Yuen, managing director for CLP: "The proposed return level fails to recognize the fundamental nature of the industry and the mount of risk undertaken by the power companies. If returns are not set at appropriate levels, the public will end up bearing the risks of insufficient investment." In its defense, CLP noted that it had not raised electricity tariffs for the past 8 years. HKE recently raised its average net tariff by 7.2%, effective January 1, 2006, but stressed that it had voluntarily foregone over HK\$2 billion

(about USD 258 million) in permitted profits between 2003 and 2005 through various rebates.

¶6. (SBU) ExxonMobil Energy Limited Chairman Brad Corson said that the proposed rate of return was not consistent with the investment risks faced by the power companies. He pointed out that the proposals could result in as much as a 50% reduction in potential returns while asking investors to face increased uncertainty with market opening proposals, greater scrutiny on capital investments, and unspecified penalties for failing to meet new environmental provisions.

¶7. (SBU) Democratic Party (DP) Legislator Fred Li told Econoff that a 9% or 10% rate of return was a "realistic and fair" number, pointing out that even pro-business Legco members like the Liberal Party's James Tien had strongly supported a 7% rate of return. Li opined that pressure from the public and from Legco will keep the HKG from compromising on the proposed rate of return, thus forcing the power companies to grudgingly accept a 9% or 10% overall rate of return. Hong Kong Environmental Protection Department (EPD) Deputy Director Roy Tang said that the power companies had "overplayed their hand," particularly regarding public opinion, and were thus in a very weak bargaining position vis-a-vis the HKG in the upcoming negotiations.

¶8. (SBU) JP Morgan's Edmond Lee said in a report that the lower rates of return would provide little incentive for the power companies to invest in new facilities. While he expected that the HKG would need to achieve some tariff cuts in order to "save face" with the public, he expected that the negotiated effective rate of return would be closer to the top end of the proposed range. However, Alice Hui of UBS Securities believes that the HKG will have the upper hand in future negotiations: "We think the two Hong Kong power companies will be fighting an uphill battle to convince both the government and the public that they need to have a return of at least 10% to continue their substantial investment in Hong Kong."

Returns Tied to Achievement of Emission Targets

¶9. (SBU) According to EPD figures, power generation

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facilities emit 92% of the sulphur dioxide and half of the nitrogen oxides in Hong Kong. Between 1997 and 2004, the emission of sulphur dioxide by power generation increased as much as 60%. In 2002, the Hong Kong and Guangdong provincial governments agreed to reduce, on a best efforts basis, the emissions of sulphur dioxide, nitrogen oxide, respirable suspended particulates and volatile organic compounds by 40%, 20%, 55% and 55%, respectively, by 2010, as compared to 1997 levels. To ensure that the power companies fully comply with the 2010 emission caps, the HKG has proposed linking the permitted rate of return on all fixed assets to the ability of the power companies to meet the emission targets. CLP has complained that the HKG cannot include such a provision in the next SCAs without first laying out a long-term energy policy that gives the power companies an idea of what they will be required to do post-2010. Alice Hui of UBS commented in a recent report that "unless the two Hong Kong power companies are able to close down all their existing coal-fired power plants and switch to natural gas-fired generation, we think it would be difficult for them to reduce respirable-suspended particulates [to the target level]. As a result, we believe that there will be no other alternatives for the two power companies to avoid the emission trading costs and penalty charges for not meeting the emission caps."

¶10. (SBU) Environmental organization Friends of the Earth (FOE) stated that the SCA consultation papers could not serve as a substitute for a proper energy policy, a policy

which should at least include: solid plans for renewables application, management of energy consumption, diversification of energy sources and the consideration of environmental performance when deciding the rate of return.

¶11. (SBU) ExxonMobil Chairman Brad Corson thought it was inconsistent of the HKG to require the power companies to meet strict emissions targets and then set the lowest proposed rate of return (7%) for emissions control investments. Why, he asked, is the HKG creating such a strong disincentive for the power companies to invest more heavily in emissions control measures? Corson flatly rejected the HKG's proposal to link the overall rate of return to performance in meeting emissions caps. He concluded that it is "unacceptable" for CLP's returns to be affected by emissions targets that the HKG can arbitrarily set without any regard for scientific, technical, or practical considerations.

¶12. (SBU) DP Legislator Fred Li, on the other hand, felt that the power companies were "lucky" to gain any return on emissions investments at all. Hong Kong should operate on a "polluters pay" principle, he continued, so the power companies should pay for their pollution by shouldering the full cost of meeting the HKG set emissions caps. However, Li said that the link between emissions performance and the overall rate of return was the single issue on which he believed the HKG was willing to compromise. He concluded that the power companies would never agree to annual reviews of their overall rates of return based upon their emissions performance and that the HKG would probably find another way to financially penalize power companies for failure to meet emissions targets.

¶13. (SBU) EPD Deputy Director Roy Tang was more confident about the HKG's ability to prevail in all of its negotiating positions. Tang discussed the February 14, 2006 death of a Hong Kong citizen who had participated in the Hong Kong Marathon on a particularly polluted day. Tang admitted that it was impossible to directly link the death of the man, who had a history of respiratory illnesses, to the air pollution. However, he continued, the Hong Kong public will long remember the images of marathon participants wearing oxygen masks against a grey backdrop of pollution-induced haze and "draw their own conclusions" about the pollution in Hong Kong. Tang felt that with the public's support the HKG's negotiating position is sufficiently strong that, if the power companies are not careful, they could walk away from the SCA talks with "completely empty hands."

Controlling "Excessive Expenditures"

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¶14. (SBU) Responding to concerns that the power companies have historically taken advantage of the fixed rate of return to over-invest in capacity, the HKG has proposed deducting 100% of any capital expenditures on generation facility machinery and equipment found to be "excessive" from the rate base. Currently, the HKG has the ability to deduct a portion of the "excess" capital expenditures (40% for CLP and 50% for HEC). However, even the HKG recognized in its proposal that such a high exclusion rate could damage Hong Kong's supply reliability by further weakening the power companies' incentive to invest based on anticipated changes in demand.

¶15. (SBU) DP Legislator Fred Li admitted to Econoff that the HKG proposal to monitor the capital expenditures of the power companies was "difficult at best." He pointed out that the HKG did not have enough technically proficient officials who could make the admittedly subjective determination as to what construed an "excessive" investment. Instead, continued Li, the HKG should set up a semi-independent regulatory body for the energy market along

the lines of the Office of the Telecommunications Authority (OFTA) and contract out positions to experts in the energy field to deal with difficult technical issues.

Proposal to Open the Hong Kong Power Network

¶16. (SBU) Although HKE and CLP have defacto service areas in Hong Kong, neither has a franchise and the power sector has technically always been open for competition. However, the fact that the two power companies are vertically integrated, combined with Hong Kong's small size and the limited availability of new sites for generation facilities, has thus far prevented any serious new suppliers from emerging. With its latest proposal, the HKG confirmed its intention to pave the way for new sources of supply by developing regulatory arrangements that allow third-party access to the power network and increased interconnection. While the HKG is not advocating introducing greater competition in the near term, it hopes its proposals will encourage more suppliers of renewable energy to build in Hong Kong, and will allow Hong Kong to benefit from any future surplus electricity from mainland China. However, given China's own electricity shortages in recent years, the HKG is cautious about relying on the mainland for electricity. One key question will be whether Hong Kong power companies are willing to open up their transmission and distribution networks.

¶17. (SBU) ExxonMobil Chairman Brad Corson opined that the HKG needs to establish principles for opening Hong Kong's power market. All players should have access to a level playing field and be subject to equivalent environmental standards and enforcement, uniform rights and responsibilities, and reciprocal market access. Corson warned that the current unclear policy toward market entrants may lead to disorder in the Hong Kong power market and possibly subject "clean power generators" in Hong Kong to unfair competition from cheap coal-burning power generators in mainland China.

¶18. (SBU) DP Legislator Fred Li said that although it is not realistic to expect real competition in the Hong Kong power market "any time soon," the establishment of an independent energy regulatory body could speed up this process significantly. The regulatory body could ensure that companies applying for access into the Hong Kong power market adhere to Hong Kong environmental standards and also provide for access to the Hong Kong power grid at established and regulated fees. Li admitted that the creation of a complete new bureaucracy would create many extra costs for the HKG but felt strongly that it would lead to a freer, more robust, and responsible power generating system in Hong Kong.

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